A STUDY OF INVESTMENT ACTIVITY OF VENTURE CAPITAL IN PRC

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Abstract

The objective of this project is to identify and evaluate the current activities of venture capitalists in the PRC. With the recent open door policy, the growth of PRC has been very rapid. The supply of funds from both short term money markets and the longer term capital markets has always fallen short of the demand from different state or non-state enterprises to keep up their growing paces.

In Chapter 1, we start off with the definition of venture capital in Asia and contrast it with the technology based venture capital in the U.S. and Europe. In Asia, venture capital emphasis is placed on direct investment in existing companies.

Chapter 2 explains our choice of research methodology for conducting interviews with six venture capitalists. The general capital market and investment environment are discussed in Chapters 3 and 4 respectively.

In recent years, many venture funds have been set up in the PRC and their investment activities provide a fertile area for exploration. Since the development of venture capital in the PRC is still far from mature, it is not easy to formulate any theoretical models for the

investment activities of the venture capitalists. However, for the purpose of this study a sequential five step model is chosen to investigate the investment activities of the venture capitalists, which were interviewed. Chapter 5 explains the five step model in greater detail. Based upon the model, an analysis of the interview results is discussed in Chapter 6.

Chapter 7 explains the threats and opportunities the industry faces as perceived by the venture capitalists, which were interviewed. Chapter 8 summarises our conclusion of the study and presents suggestions for further study.

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Our special gratitude must be given to the anonymous interviewees. This project cannot be accomplished without the kind and gracious help from the six venturists, who allow us to interview them. According to the ground rules of the study, it is required that they remain undisclosed.

CHAPTER 1

INTRODUCTION

Project Objective

The purpose of the project is

1. To identify and evaluate the current activities of venture capitalists in the PRC. A modified model is derived from the literature research in order to depict all the venture capitalists' investment activities in the unique setting of investing in the PRC.

2. To draw a picture on the threats and opportunities in the industry as perceived by the venture capitalists.

During the progress of the project, we found that the venture capital industry is extremely competitive and thus, information is very restrictive. Although the H.K. Venture Capital Association has been approached, only limited public information has been obtained on the current situation in the industry.

Definition

During the startup phase of a business, which may involve a new product or concept, the financing of the company mainly comes from the entrepreneur himself, plus adoring relatives or long time friends or business contacts who have enough faith in his abilities to believe that he is going to repay the loan, let alone offer a good return. The higher than average risk related to this sort of projects forbids the banks and financial institutions from this market. It leads to the emergence of the venture capitalists : who specialise in discerning promising start-ups, and getting a higher return from their equity participation in new ventures. By spreading among a portfolio of startup companies, the risk of the venture capitalist can be spread.

The venture capital industry is, thus, in the business of promoting growth and managing risk. A venture capital firm serves as an intermediary between investors looking for high returns and entrepreneurs in need of capital.

In U.S., venture capital financing has been popular for about 30 years. It usually refers to equity investments in young, rapidly growing (and often) high-tech companies.

In Asia, the meaning is more flexible. Broadly speaking, venture capital refers primarily to equity investments in growing, unlisted companies[1]. The investment scope covers companies at all stages of

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1 "Asia Tests New Funding Concept" in Asian Finance Jan 90, Pg. 38-41

maturity and in virtually every industry. In the business environment of China and Hong Kong, most of the venture capitalists are simply making direct investment, that is not intending to invest in startup or hi-tech businesses, but just to obtain equity holdings directly in unlisted companies, which may be able to go listing in a few years time. In PRC, the only company that specifies itself to hi-tech ventures is China Venturetech Investment Corporation[2].

Nature of Venture Capital

A number of features of venture capital financing distinguish it from other types of finance to a company, e.g. bank overdraft facility, bank loans.

1 It provides medium to long term finance (2 - 5 years) for entrepreneurs.

2 It provides management and technical assistance (value added services) e.g. alliance of strategic partners, recruit key personnel.

3 It is an equity investment that generates long term capital gains. Each venture capitalist may look for different time frame and depends on the terms and conditions in setting up the fund.

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2 China Venturetech Investment Corporation was set up in Peking in 1986 with an original rationale to channel funds into technology-related ventures and help new company. in science and technology. Its two main backers are the Ministry of Finance and the State Science and Technology Commission. Its offspring in Hong Kong is the China Assets, which is listed in HKSE. (Far Eastern Economic Review, 'Investment - Maximum Bullish ' 16 December 1993.)

4 Considerations for providing funding are the management team and market potential rather than collateral.

5 High perceived risk to the expected return.

Stages of development

The different stages of a venture development can be analysed as below

1 **Seed** : initial concept of business is being formed. At this time, working models of products are being researched, planned and developed. Often entrepreneurs can finance this stage from their personal resources.

2 **Start-up** : operation is formalised and the product or service is developed and produced at this stage. Investment in facilities and operating equipment is required. This can be the riskiest stage since funding requirements may be fairly large, yet the business has no track record. Most companies fail during the start-up period. The start-up phase can be as short as six months or as long as four to five years depending on the industry.

3 **Early Stage** : With the establishment of a product line with a sizeable scale according to the resource availability of the entrepreneur. The market is still at its early stage and the size is limited.

4 **Expansion** : Having built up a track record, the company seeks additional capital to expand production or marketing capacity. However, it is still too early to think about a stock exchange listing. Bank financing may be available, but personal guarantees from directors and collateral are usually necessary. During the development stage there may be several rounds of venture capital raising.

5 **Mezzanine (Pre-Initial Public Offering)** : This is most often the last stage of venture capital raising before the company goes public. Mezzanine fund raising may be intended less to raise capital than to bring in strategic shareholders as a part of preparing for an upcoming public offering. The financing may have certain aspects of "window dressing" that are not as important in earlier stages. Mezzanine exercises also permit cleaning up of the balance sheet before going to the stock exchange.

In Asia, the venture capitalist mainly targeted at companies at the stage of expansion and mezzanine (Pre-IPO) rather than seed and startup[3].

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3 Guide to Venture Capital in Asia (1992-1993 Edition)

Venture Capitalist Activities

The activities of a venture capitalist can be depicted as below.

1. Fund Raising - to set up the fund and seek for subscribers.

   Decisions should be made on

   i. whether a closed/open end[4] is to be set up;

   ii. whether the fund is listed or non-listed; and

   iii. the maturity period for the fund.

2. Fund manager's activities - the core investment activities to deploy the fund. It includes searching, evaluating, negotiation, monitoring and exiting.

3. Distribution of returns to shareholders - It is stipulated in the prospectus and usually takes the form of dividend payment. However, the fund manager usually has the right to retain any portion of the profit for further reinvestment.

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4 For closed end fund, its basic capitalization is limited. After the initial offering, an investor can only buy the shares from another person. Normal commissions are paid on such transactions. The price of a closed-end fund may be at a premium or discount to its net asset value per share. Therefore, there is an added source of risk and potential return to the investor. An open-end fund does not have a fixed capitalization. It sells its shares to general public at its net asset value per share and stands ready to repurchase back at the same price. (From "Modern Investments and Security Analysis" by Russell J. Fuller & James L. Farrell, Jr. Pg. 561-563)

CHAPTER 2

METHODOLOGY

Research Strategy

Literature review and preliminary interviews with practitioners in the industry were conducted. There are a number of books describing the experience in the western world but they lack application to S.E. Asia and China. There are also models which describe the decision making process of the venture capitalists but they have not been judged in terms of their application to the investment environment in China. There is no established theory to extend or accepted hypotheses to empirically test as well. In this aspect, the study takes the approach of field study from a sample of venture capitalists with an aim to providing a descriptive model of venture capital decision-making. The study was designed to address the following topics

i. The venture capitalist's activities which includes proposal generation, screening, evaluation, negotiation, monitoring and cashing out.

ii. The venture capitalist's views on the future opportunities for the industry in PRC as well as potential threats.

Other areas of venture capital were not included in the scope of the study, namely :

i. Legal aspects; and

ii. Ongoing venture evaluation, involvement in operations of portfolio companies, and management consulting.

Interview Generation

Within this framework, an interview guide (Appendix I) was developed for use in conducting face-to-face interviews with the venture capitalists. The guide provided a structure for the interview and helped ensure consistency between interviews as well as comprehensiveness. However, it is not a rigid questions and answers in order to allow flexibility with an open and smooth atmosphere. During the conduct of the interview, rigid lists of questions were avoided.

Venturists at six venture capitalist companies were contacted. Their profiles are listed as below.

Firm A - A company specialised in direct investment over the whole S.E. Asia region.

Firm B - A subsidiary of a well established U.K. merchant bank.

Firm C - A subsidiary of a big international insurance company.

Firm D - A Hong Kong investment company whose major shareholder/director had strong China contact.

Firm E - A local investment company with a number of joint ventures with another PRC partner.

Firm F - The direct investment arm of a large local bank with representative offices in PRC.

Some of the interviewees were given the guide beforehand in order to facilitate the session with their prior understanding on the scope of the study. Venture capitalists have a reputation for keeping confidentiality about their activities and deliberately maintain low profiles. Therefore, there was not much chance to explore in detail their decision making process. However, one venture capitalist provided us with a description of their decision making process which involves a very structured approach. They were all willing to provide us the composition of their current investment portfolios at the time of the interview. One publicly listed firm expressed concern about listing restrictions which prevented them from giving full details until they were publicly announced. Portfolio composition by industry and geographic locations was obtained for the entire sample.

Interview Description

The interviews were begun by explaining to the venturists :

i. That the information being collected was to be used in a MBA report;

ii. That neither their identity nor the identity of companies learnt about in the course of the interview would be disclosed;

iii. The status of the project;

iv. The kinds of information being sought; and

v. The permission for type recording.

During the interviews, open-ended questions were usually used to seek more comments and ideas from the interviewees. In addition, the interview guide was referred to ensure that all the questions were well-covered. Each of the interviews took approximately one and a half hour to two hours and interview reports were prepared each time to assist the later analysis process.

Research Limitation

In any methodology involving self-reporting, the validity of the responses is a concern. Ericsson and Simon (1984) outline eight conditions under which verbal reports will be most accurate[5].

i. the information reported is the focus of attention

ii. the task is not highly rountised

iii. a short time elapses between task and recording

iv. verbalisation does not require excessive encoding

v. the reports are oral

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5 Details are described in "Protocol Analysis: Verbal Reports As Data" by Ericsson, K.A., and Simon, H.A. 1984. Cambridge, MA:MIT Press

vi. subjects are free of distractions

vii. the questions and instructions on how to verbalise are clear and specific

viii. the reports are as complete as possible

The design of the study was not intended to go into the details of due diligence, evaluation criteria and the specific kind of information reviewed for each investment, but on the overall flow of the decision making process.

A practitioners' list and contact person was difficult to obtain. The Venture Capital Fund Association in Hong Kong is also restrictive for members and only limited information as well as contact could be obtained. The resulting small sample size might raise scepticism when attempts are made to generalise behaviour to a much larger group. However, the report aims at providing a framework and recommendations. It tries to sketch the existing picture of the industry through a refinement of the ideas from different experts in the field.

Duplication of this type of study is impossible. A limitation also lies in the incompleteness of data as some interviewees were rushed for time. Poor interview techniques might also contribute to a conclusion not truly representing the whole picture. We have been trying to minimize the impact of these limitations by sending the interview reports to the interviewees for verification.

Chapter 3

Environment : Capital Market in China

Economy in China

As a result of the reforms initiated in 1978, the economy of China has become one of the most dynamic in the world. During the 1980s, GNP grew at an average rate of 9.2 percent, average per capita income doubled, the incidence of rural poverty was reduced to about 13 percent, and investment and saving were maintained at high levels. The reforms improved incentives and productivity by decentralising economic decision making, giving greater autonomy to enterprises, farmers and localities, according a larger role to markets, and opening the domestic economy to the outside world.

Although austerity measures were launched to curtail the overheat in 1987 and counter the inflation, the GNP still sustained growth at 4 - 5 percent. This has in fact lowered the inflation rate and returned China's trade account to a surplus. It is also observed that the main growth rate was contributed by the industrial sectors.[6]

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6 Prospectus for shares issued by China Assets (Holdings) Ltd. in April, 1992. (Pg.31-37)

Table 3.1

Major Economic Indicators for PRC from 1987 to 1992

	1987	1988	1989	1990	1991	1992[7]
Gross National Product (± %)	11.0	10.8	4.0	5.2	7.5	12.8
Gross Domestic Investment (% GNP)	37.2	38.4	37.6	35.1	39.4	37.0
Gross Domestic Saving (% GNP)	35.9	36.3	36.0	37.3	40.3	38.2
Resource Gap (% GNP)	**-1.2**	**-2.1**	**-1.6**	**2.2**	**-0.9**	**1.2**
Inflation Rate (± %)	8.8	18.5	17.8	2.1	3.0	10.9
Merchandise Exports (US bn)	34.7	41.1	43.2	51.5	59.2	85.8
(± %)	34.9	18.2	5.3	19.2	15.0	18.3
Merchandise Imports (US bn)	36.4	46.4	48.8	42.4	50.0	80.6
(± %)	4.3	27.4	5.3	-13.3	18.0	26.3
Trade Balance (US bn)	-1.7	-5.3	-5.6	9.1	9.2	5.2
Current A/C Balance (US bn)	0.3	-3.8	-4.3	12.0	12.2	11.5
(% GNP)	0.1	-0.9	-1.0	3.2	3.3	2.1
Exchange Rate (annual average) - RMB/US	3.7	3.7	3.8	4.8	5.4	5.4

Source : Asian Development Bank, derived from People Republic of China, State Statistical Bureau, Statistical Yearbooks of China 1989, 1990 and 1991; International Monetary Fund, International Financial Statistics (Dec 1989, Jan 1991, Feb 1992 and Feb 1993); World Debt Tables, 1989-90 Vol. 2, 1990-91 Vol.2 and 1991-92 Vol. 2 and 1992-93 Vol.2)

It is observed that the resource gap will be further aggravated with the recent growth rate in China. The venture capitalist can help to fill in the gap where under the austerity policy, general loans are not easily raised to finance enterprise expansion.

7 Forecast from China Monthly Statistics 1993, Asian Monetary monitor 1993, China Economic News 1993, China Trade Report 1993, Asian Development Outlook 1992.

Industry

China's economy is divided into three sectors : the state sector, the collective sector and the private sector (which comprises the individual and foreign-invested enterprises sectors).

Table 3.2

Growth in Industrial Output in PRC (%)

	1986	1987	1988	1989	1990	1991	1992	Mar 1993[8]
Industrial Output	11.1	16.5	20.7	8.3	7.6	14.2	20.8	22.4
1. By industry								
- Light Industry	12.7	16.8	22.6	8.4	9.1	14.5	20.9	18.3
- Heavy Industry	9.6	16.0	18.8	8.2	6.0	13.9	20.7	26.3
2. By Sector								
- State Owned	6.2	11.0	12.7	3.7	2.9	8.4	14.4	8.7
- Collective	16.7	25.0	28.8	10.7	9.1	18.0	28.5	42.7
- Rural	-	-	35.0	12.7	12.5	25.5		
- Individual	60.6	48.0	46.0	24.1	21.6	24.0	48.8	63.6
- Foreign-invested	34.3	98.0	97.0	44.7	56.0	55.8		

Source : State Statistical Bureau of China

The state sector has been the largest contributor to industrial output, but is declining in importance because of its low efficiency, large stockpiles of unsold goods and bad debts. On the other hand, the non-state sector, which includes collective and private sector, has gone through rapid expansion. There has been extremely rapid growth in the foreign-invested enterprises sector. Foreign investment has been encouraged by the creation of

8 China Economic News, March, May 1993; China Trade Report, April 1993; Economic Reporter No.5, 1993.

special areas or zones, generally situated in the coastal provinces whose general aim is to attract foreign investment and technology by offering a variety of investment incentives, including preferential tax treatment, to foreign businesses[9].

These areas/cities includes

1. Special Economic Zones like Shenzhen, Shantou and Zuhai.
2. 14 coastal cities (see Appendix II).
3. The Coastal Open Economic Zones, e.g. Shandong Peninsula, the Yangtze and Pearl River Deltas, etc.
4. The Pudong New Area in Shanghai.
5. 27 High and New Technology Industrial Development Zones e.g. Beijing, Changchun, Changsha, Chengdu, Chongqing, etc. Enterprises have to be also confirmed as technology intensive in accordance with the requirements formulated by the State Science and Technology Commission.

Under the economic reform, state enterprises are responsible for their own profit and loss. They have to improve their efficiency by investing in advanced machinery. There is also a strong demand of capital from the state enterprises and non-state enterprises to expand in meeting the growing demands both internally and

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9 Prospectus for shares issued by China Assets (Holdings) Ltd. in April, 1992. (Pg.31-37)

externally. Under the austerity program, bank loans are extremely difficult to obtain. Equity joint venture or cooperative/contractual joint venture is therefore sought for the source of finance. While venture capitalists usually look for a minority equity investment without desire to gain management control, they provide a well-fitted source of the capital. Furthermore, usually, venture capitalists can provide value added service such as management advice, aligning strategic partners and possibly assist in the preparation for public listing. It is therefore a most welcomed provider of finance to these enterprises.

Based on this, the China economy and industry remains attractive for foreign investment despite the high inflation and likelihood of further depreciation of the RMB. In 1992, over 84,000 foreign-funded enterprises were approved by Chinese officials. The value of the foreign investment is estimated to be US$178.46 billion.

Unification of Exchange Rate

Before 1994, the black market price of RMB deviated significantly from the official rate set by the government. There were also stringent exchange controls and restrictions on conversion from RMB into foreign currency. The Foreign Exchange Adjustment Centres allowed foreign investors to swap their RMB profits for foreign exchange or swap foreign exchange for

RMB to pay local expenses at a stipulated rate set daily by the government. From January 1994, the government unified the exchange rate which made the adjustment centres obsolete. As a result, the RMB is now at a controllable floating rate against US$. It is foreseen that foreign investment will have material impact resulting in fluctuations in the currency. Therefore, venture capitalists should consider exchange risks in computing their rate of return.

Tax Reform

From 1st January 1994, there is a unified tax law which is administered throughout the whole countries. Six tax categories are established to unify the sundry local and central tax that was levied previously.

i. Value Added Tax
ii. Corporate Income Tax
iii. Individual Income Tax
iv. Capital Gain Tax
v. Consumption Tax
vi. Business Tax[10]

As the preferential tax for foreign investment are reassured by the Government, it is foreseen that this

10 "China's new Taxes Puzzle Foreigner" - Asian Wall Street Journal, Jan 3, 1994.

will not deter the desire for foreign investment. The more systematic tax system should remove the uncertainty element and facilitate the evaluation process by the venture capitalists.

Stock Market Development in China

There are currently two stock exchanges in China : Shanghai and Shenzhen. The development of a primary share market began in 1983 when enterprises were allowed to raise funds through issuing bonds and shares. Over-the-counter secondary markets for securities began officially in late 1986 in Shenyang and Shanghai and have since spread to about 50 large and medium-sized cities all over China. The shareholding system has been extensively promoted and tested with the aim of supplementing the contract responsibility system as a measure of enterprise reform.

The driving forces behind stock market development in China have been

1. Insufficient resources of the State to continue to provide high levels of financial subsidy to inefficient money-losing state enterprises.
2. Lack of funds for capital development by the State while large amounts of funds are held by the public in the form of bank deposits and cash.
3. A desire to have investors allocate capital so as to improve the efficiency of state enterprises. This

would help reduce government budget deficits and release funds for key capital development purposes.

4. A desire to facilitate macroeconomic control of inflation by switching funds from consumption to investment.

Although a few stocks are listed in the Shenzhen Stock Market, the market capitalisation was RMB 16,513 mn for all A and B share after the first three years of operation in 1992. This compares with Shanghai which had a market capitalization of only RMB 4,787 mn.

B shares are those registered shares denominated in RMB and offered exclusively to foreign investors for purchase and sales using foreign exchange. Shares owned by Chinese legal and natural persons which are purchased and traded exclusively in RMB are known as A shares. The issuance of B shares is one of the most inexpensive means for PRC enterprises of raising capital in foreign currency, and this type of fund-raising exercise is likely to become more popular among Sino-foreign joint ventures. Rules which provide details on the issuance, trading, settlement and taxation of B shares have been enacted.

Although there isn't a well defined body of legislation which applies to the China stock market as compared with the stock markets in western world, the rapid development of China's economy has fostered an active secondary market and enabled state enterprises to seek listing as a source of finance. However, there are limited number of companies that can be listed in both markets per annum. As a consequence, enterprises still need to hunt for short to medium source of finance with the hope of arranging to be listed afterwards. Venture capital fund seems to fit in the capital gap in the short run.

The recent prospering stock market and increased public awareness have provided a very good exit channel to venture capitalists for cashing in their investment after five - seven years' time.

Chapter 4

Venture Capital Investment in China

There is a lack of public information available about the industry because of the low profile of the market players. Therefore, only limited public information is available.

The following are extracted from The Guide to Venture Capital in Asia, published annually by the Asia Venture Capital Journal. The geographic scope of Hong Kong has been merged with China as most of the funds raised in Hong Kong nowadays are targeting at investment in the nearby China economic zones. There are also funds which are raised exclusively within China.

From the preceding figures, it is clear that there has been a rapid increase in the funds raised and invested in the recent years. The total amount of venture capital fund investment has increased from US$1,113 mn to US$1,484 mn (+33%). The growth of the pool size has continued with an average of 38 percent over the four year period. Except in 1991, new funds have been raised to fulfill the market demand and in 1992, it increased more than 137 percent. It indicates that the industry has sustained continued growth with the existing market situation. The fast development of the stock market in PRC or provision of the overseas listing opportunities further enhance the exit channels of the venture capitalist under the continuing open policy and market economy in China.

Table 4.1

The Current Venture Capital Fund Position for HK/PRC [11]

Hong Kong/China	1988	1989	1990	1991	1992
Number of firms	19	32	35	38	48
Venture Capital Pool[12](US$mn)	926	1325	1806	2136	2656
New Fund Raised [13] (US$ mn)	-	398	652	530	710
Total Amount Invested[14](US$mn)	-	-	800	1048	1210
China					
Number of firms	3	6	6	8	18
Venture Capital Pool (US$mn)	47	112	113	184	878
New Fund Raised (US$ mn)	-	64	1	16	583
Total Amount Invested (US$ mn)	-	-	-	65	274
Total					
Number of firms	22	38	41	46	66
Venture Capital Pool (US$mn)	973	1437	1919	2320	3534
New Fund Raised (US$ mn)	-	462	653	546	1293
Total Amount Invested (US$ mn)	-	-	800	1113	1484
Increase % from previous yr					
Number of firms	-	73	8	12	43
Venture Capital Pool (US$mn)	-	47	34	21	52
New Fund Raised (US$ mn)	-	-	41	-16	137
Total Amount Invested (US$ mn)	-	-	-	39	33

11 The Guide to Venture Capital in Asia (1993) by AVCJ.

12 The total Amount of Venture Fund that is available for equity investment directly in HK/PRC by the year ended 31.Dec.

13 Funds that is raised in the year.

14 The total amount that have been committed into different ventures.

The breakdown of investment in PRC by sectors in 1992 was:

- Consumer 41%
- Manufacturing 22%
- Others 37%

Also in 1992, the majority of the investment was made to companies on expansion/pre-IPO stage (74 percent) while for those at seed/startup stage amounted to just 5 percent. This, however, coincides with the usual Asian venture capital scenario[15].

15 AVCJ survey for the 1993/94 Guide to Venture Capital in Asia.

CHAPTER 5

A MODEL OF ANALYSING VENTURE CAPITALIST'S INVESTMENT ACTIVITY

The detailed profile of the six venture capitalists interviewed is listed in Table 5.1 Company Profile. The general feeling from the venture capitalists was that they viewed every deal and venture fund to be peculiar to itself and then resisted generalisation. However, from the analysis point of view, a model of their investment must be formulated in order to provide a basis for comparison. Also the model helps to give insight on how the venture decision process might be improved.

As we mentioned in chapter 1, the nature of ventures in the PRC are different when compared with those in Western countries. However, we found that their investment activities looked fairly similar. Thus the decision models established in the Western countries will be used as a reference for our study. Four researchers have studied venture capitalist's decision-making from a process perspective (table 5.2)[16].

16 "Venture Capitalists' Decision Criteria in New Venture Evaluation" by John Hall, Journal of Business Venture 8, 1993

TABLE 5.1

COMPANY PROFILE

	Firm A	Firm B	Firm C	Firm D	Firm E	Firm G
Portfolio size	US$400 Million	US$60 Million	US$100 Million	US$18 Million	US$25 Million	US$45 Million
Fund Characteristics	10 years, closed-end	12 years, closed-end	7 Years, closed-end	Closed-end	N/A	7 Years, closed-end
Number of ventures invested (1993)	0	5	2	4	7	5
Typical deal size	> 3 Million	> 3 Million	2-10 million	2-3 million	2-3 Million	5-10 Million
Geographic preferrence	None	None	Pearl River Delta	Coastal province	Yangtze River Delta & coastal provinces	None
Financing Stages	All stages, includ. start-up	Established enterprise for expansion	Growth and refinancing	Expansion	Expansion, only	Expansion only
Ventures in the portfolio	Light industries	Light and semi-heavy	Light	Light and property development	Light industries	Light and property development.
Total time taken for making investment decision	3 months	4 weeks	Approx. 6 months	Ave. 3 months	6-12 months	6-8 weeks
Number of proposals rec'd in last 12 months	100 deals	100 deals	40-50 deals	Approx. 20 deals	Approx. 100 deals	Approx 140 deals
Source of proposals	a. Rep. offices	a. Personal contact	a. Merchant bank b.Personal contact c. China partner - a provincial government	a. Provincial govn't b. Personal contacts c. Rep.offices in Beijing and Nanjing	a. Rep. office in Shanghai	a. Bank's 13 rep.office b. Merchant banks and other V.C. c. Company's direct contacts

Table 5.2

Stages of Venture Capitalists' Management Process

	Wells (1974)	**Tyebjee & Bruno (1984)**	**Silver (1985)**	**Hall (1989)**
1.	Search	Deal origination	Search	Generating a deal flow
2.	Screening	Screening	Initial screen	Proposal screening
3.	X	X	X	Proposal assessment
4.	Evaluation	Evaluation	X	Project evaluation
5.	X	X	Due diligence	Due diligence
6.	X	Deal structuring	Deal structuring	Deal structuring
7.	i. Venture board meeting ii. venture operations	Postinvestment activities X	Monitor progress X	Venture operation X
8.	Cashing out	X	Cashing out	Cashing out

Comparison of four decision models

In the first of these studies, Well (1974)[17] identified six distinct stages in the venture funding decision process through interviews with seven venture capital firms. These stages were :

1) The search for investment opportunities, which involved the contacts with the banks and other venture capital firms;
2) The screening of proposals, in which a standard format of questionnaire were answered;
3) The evaluation of proposals, which investigated the proposed deal as thorough as possible;
4) In venture board meetings and follow-up;
5) In dealing with venture operations; and
6) In cashing out of the ventures.

In a study by Tyebjee and Bruno(1984)[18], a five-stage model of venture capital investment activity was identified. The five stages were :

1) Deal originating, or screen for potential investments;
2) Screening;
3) Evaluation;

17 "Venture Capital Decision Making" by Wells, W.A. 1974. Unpublished doctoral dissertation, Carnegie Mellon University, Pittsburgh.

18 "A model of venture capitalist investment activity" by Tyebjee, T.T. and Bruno, A.V. 1984. Management Science 30:1051-1066.

4) Deal structuring, during which the venture capitalist and the entrepreneur negotiate and agree to specific financial and convenant arrangements; and

5) Post-investment, which involves all the activities of the venture capitalists after investing in the new venture.

Basically, Tyebjee and Bruno's model combined the fourth and fifth stages of Well's model into a single stage - post-investment, and added a new stage called deal structuring.

In a study by S. David Silver(1985)[19], the venture evaluation process was described in six stages. The six stages were :

1) Search;

2) Initial screen, in which most proposals were rejected;

3) Due diligence, which involves a series of five audits : the size of the problem, the business is attempting to solve, the elegance of the solution, the entrepreneurial team, the financial statement, and legal aspects;

4) Deal structuring;

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19 "Venture Capital: The Complete guide for Investors." by Silver, A.D. 1985. New York: John Wiley and Sons.

5) Monitor progress, exert control and attempt to add value to the new venture; and eventually
6) Cashing out.

Finally, in study by Hall(1989)[20], eight stages in the venture capitalists' decision processes were identified:

1) Work aimed at generating a deal flow;
2) Proposal screening, in which the proposal was briefly assessed;
3) Proposal assessment, when the proposal was assessed in more details;
4) Project evaluation, during which the venture capitalists actually toured the business and/or met with entrepreneurial team;
5) Due diligence;
6) Deal structuring;
7) Venture operation; and
8) Cashing out.

The most significant discovery from this review is that although the stages in the models look similar, the process model has evolved from a less mature framework (Wells 1974) to a more mature and sophisticated framework (Hall 1989). The evolution basically reflects

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20 "Venture Capitalist Decision Making and the Entrepreneur: An Exploratory Investigation." by Hall, H.J. 1989. Unpublished doctoral dissertation, University of Georgia, Athens.

different levels of maturity of venture capital industry in United States.

The development of venture capital in the PRC is still in the early stage. It is inappropriate to apply the sophisticated model established by Hall (1989) to the investment environment in PRC. For example, the Hall model has eight stages of decision process placing high emphasis on the proposal screening and assessment stages. In the PRC, many ventures don't have any proposal in the first place and the proposal formats and quality vary greatly. Thus, in making deals, the role of the proposal is less important in the PRC ventures as compared with the United States ventures.

On the other hand, the Tyebjee & Bruno (1984) model best describes the investment activity in the PRC. The model is simpler and its focus is more on deal sourcing, evaluation, pricing and the structuring, which matches the present phenomena of the venture capital industry in the PRC. The Bruno model is therefore chosen for our study.

Tyebjee & Bruno's decision model

As mentioned previously, in the Tyebjee & Bruno model (Fig. 5.1), the investment activity is modelled as a sequential process with five stages. The salient features of each of these stages, which are applicable to the PRC, are described in details below :

Deal Origination

The venture capitalist has to find prospective deals under a poorly defined and ill-informed environment, information is restricted to a network which is not publicly accessible. The typical investment prospect is too small a state-enterprise, collective enterprise or private enterprise to be readily identifiable as a potential candidate. Therefore, we would expect that various intermediaries such as merchant banks, provincial government and industry council, play an important role in matching venture capital investors with those venture with cash needs.

Screening

Venture capital firms typically have small staff[21]. One of the interviewed firms has six professional staff and they claimed to be the largest in Hong Kong. As a result, the firms must screen relatively large number of potential deal and invest only on a fraction of deals which catch their attention. Their screening criteria

21 "A model of venture capitalist investment activity" by Tyebjee, T.T. and Bruno, A.V. 1984. Management Science 30:1051-1066.

reflect a tendency to invest in those areas with which the venture capitalist is familiar, in terms of the geographic location, industry or market of the venture.

Evaluation

Most ventures in need of capital are enterprises which have little or even no operating history under market economy. Therefore, the venture capitalist has to rely on a subjective assessment of business plan as well as the competence of the venture management to take on a new product. Venture capitalists do weigh risk and return, and subsequently formalise this assessment into a computation of an expected rate of return IRR, but personal feeling seems equally important when determine whether or not to invest in a particular deal.

Deal Structuring

Once the venture capitalist has determined to invest in a deal, he and the venture management will negotiate and structure a mutually acceptable venture capital investment agreement. From the venture capitalist's perspective, the agreement serves several purposes. Firstly, it establishes the agreeable price of the deal, which is not easy since China is having a different accounting standard, which influences the way the asset and profit shown in the financial statements of the enterprise. Secondly, it establishes protective covenants which restrict the power of venture management to the manageable extent even though the venture capitalists hold a minority position. Thirdly, it establishes the equity stakes among different investors, including the corporate investor(s) and other venture fund, if any. Since any change of the deal price and equity stakes would affect the investment's return, this step is an iterative process and has a mutual dependency with the previous Evaluation step.

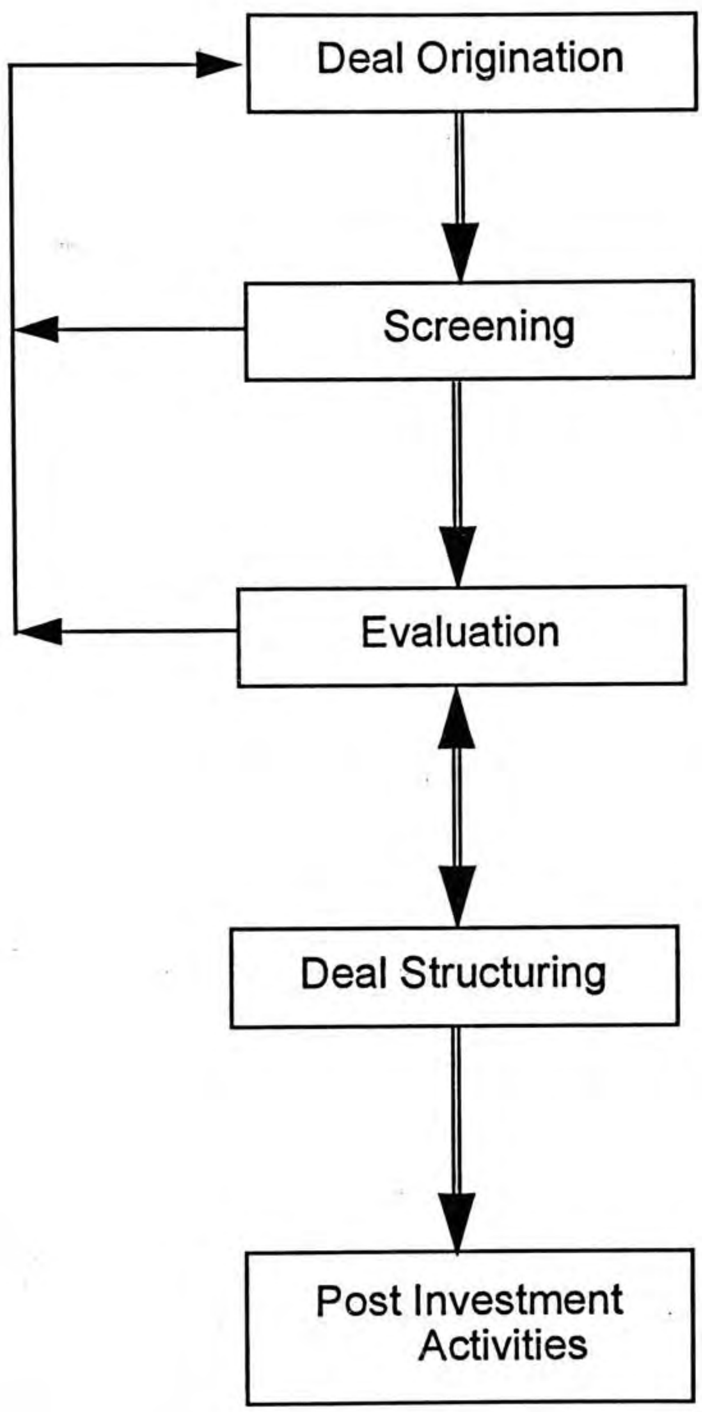
Post-investment

Once the deal has been consummated, the role of the venture capitalist expands from investor to collaborator. This new role may be via the formal representation on the board of directors and/or via informal influence to the venture by aligning foreign business partner. The intensity of involvement in the venture's operations differs from one venture capitalist to another. Unlike their western counterparts, more than half of the interviewed venture capitalists believe that it is desirable to exert control over the day-to-day financial issues of the venture.

Finally, the venture capitalists typically want to cash-out their gains five to seven years after initial investments. To this end, they play an active role in directing the venture company towards public offering, merger or acquisition.

Fig 5.1

Model of Venture Capitalist Investment Activities



CHAPTER 6
AN ANALYSIS OF THE VENTURE CAPITAL INVESTMENT ACTIVITY IN PRC

Step 1 - Deal Origination

In the interviews, we identified six deal sources which might be utilized by the venture capitalists in varying degrees. They are a) representative office, b) investment manager's personal contact, c) merchant banks, d) China partner, e) provincial government, and f) company's direct contact (see table 6.1). The most common source is the referrals from the firm's representative office in some major cities, e.g. Shanghai and Beijing. Four firms were found to utilize this approach with two of them - Firm A and E utilizing it much more than the others. They both shared the belief that the selection of project should depend on the local environment and only local people understand their environment and business needs, and thus reducing the investment risk.

Each firm has its focused deal source and depends on either the company or the investment manager's competitive advantage(s). For example, one of the firms' investment manager was previously the Chief Representative of the Hong Kong Trade Development Council in China. His extensive China experience as well as his wide personal network help the firm to generate substantial deals.

TABLE 6.1

STEP 1 - DEAL ORIGINATION

Stages of the model	Firm A	Firm B	Firm C	Firm D	Firm E	Firm F
Step 1 - Deal Origination						
1. Represetative office	X/F			X	X/F	X
2. Personal contact of the investment manager		X/F		X		
3. Merchant bank			X/F			X
4. China partner		X				
5. Provincial government			X	X/F		
6. Company's direct contact						X/F

Note :'X' refers to the deal source being selected by the firm
'F' refers to the deal source emphasized by the firm.

Firm F, a subsidiary of a local bank, gets the majority deals from the bank's 13 representative offices as well as the bank's direct contact. It is interesting that there is no single source which dominates the deal generation and it is all on the discretion to the investment manager to emphasize the source(s) which generate most deals and best suit the firm's investment strategy. Based on the interview results, there was no correlation between the number of deals being screened and the types of deal source.

Deal flow is a measure of how many ventures or deals that are screened in certain period. It is important because if the firm has a strong deal flow, it implies that the firm has a higher chance of selecting the good investment. The deal flows of the interviewed firms were varied from 20 to 140 deals over the last 12 months. It is still fairly low as compared with the US counterparts in which the deal flow is about 400 to 500 a year[22]. The relatively low deal flow may be attributed to the concept of venture capital, which is just started to be known in China's enterprises, and the low profile of the venture capitalists which makes it difficult for them to compete with the banks and other corporate investors. In fact, only one of the firms mentioned marketing in order to

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22 "Venture Capital at the Crossroads" by Bygrave, W.D. and Timmons, J.A. Harvard Business School Press Boston, Massachusetts.

expose the venture fund to some target business segments and government agency.

Step 2 - Screening

As the venture capital firms normally have a small staff, a crude screening criteria are used to reduce the proposal to a manageable number for more in-depth evaluation. The initial screening is based upon four criteria; namely 1) the size of the investment and the investment policy of the venture fund, 2) geographic location, 3) stage of Financing and 4) industry preference (see table 6.2).

The size of the investment and the investment policy of the venture fund

Size of investment

The lower limit of the deal size is determined by the fact that the firm is not justified to spread its portfolio over too many small investments, since the subsequent monitoring and control activities would take virtually identical resources regardless of the size of investment. Firm E has a lowest limit US$0.5 million which is understandable because the firm has a large workforce of about 20 staff in their Shanghai local office. The relatively low overhead there can help to keep the smaller size of investment in their portfolio.

TABLE 6.2

STEP 2 - SCREENING

Step 2 - Screening	**Firm A**	**Firm B**	**Firm C**	**Firm D**	**Firm E**	**Firm F**
1. The size of the investment and the investment policy of the fund						
- Deal size	> 3 million	> 3 million	2-10 millions	1-5 million	0.5-5 million	2-22 million
- Equity %	30-70%	25-40%	about 25%	25-35%	10-35%	10-35%
- at least one seat on board	Yes	Yes	Yes	Yes	Yes	Yes
- partnership with other investment company	No	No	Yes	Yes	Yes	Yes
- go listing for certain period	5-7 years	4-5 years	Max 7 years	Max 5 years	Not fixed	5 years
2. Geographic location	None	None	Pearl River Delta	Coastal provinces	Yangtze River Delta and coastal provinces	None
3. Stage of financing	Start-up & Expansion	Expansion & Pre-IPO	Expansion	Expansion	Start-up Growth & Expansion	Growth, Expansion & Pre-IPO
4. Industry	None	None	None	None	None	None

The upper limit is determined by the capitalization of the portfolio and the desire to diversify the investments within the portfolio. However, the upper limit is relatively flexible because for those larger deal the capitalist can solicit the participation of other venture capital funds or corporate investors, if the investment policy allows partnership with other investment companies.

Partnership with another investment company

Two of the interviewed firms, A and B do not allow co-investment with third parties. They prefer a one-to-one joint venture for their investment so that the venture would have a clear objective and goal, and hopefully less conflicts on the board. Of course, this restriction would limit their choice of venture candidates should the size of investment exceeds their upper limit of their investment policy.

Equity percentage

The equity percentage is determined by the stage of financing of the venture as well as the regulation of the stock exchange if the venture fund is listed. For example, if the venture is a new start-up and the risk factor is very high, venture capitalists would ask for at least 70 percent of the ownership. In contrast, when the venture consists re-financing an existing enterprise, the firm will normally only be a minority shareholder.

The funds managed by firm E and F are listed on Stock Exchange of Hong Kong. According to the Exchange's listing rules, the equity interest held by the firm in each investment project must not be more than 35 percent[23].

At least one seat on the board of director

It is not surprising that all the interviewed firms are required to have at least one seat on the board of directors. This criterion is considered to be a minimal measure to protect the interests of the firm even though they are a minority shareholder of the venture.

Obtain a listing within certain period of time

According to one of the investment manager, 'cash out or exit' is the most important factor for him to consider the investment, and public offering is the most desirable way for the venture capitalist to cash out. In US, the venture capitalists normally want to cash-out their gain five to ten years after initial investments

23 "Rules governing the listing of securities on the Stock Exchange of Hong Kong Ltd." Vol 1 Chapter 21 - Investment Companies.

(Bruno 1984). From our interviews, we found that the firms expect to obtain a listing in a shorter time span of five to seven years, which is understandable given the China market is still far from mature and many risk factors have to be considered (Details of the risk factors will be discussed in Chapter 7).

Geographic Location

From our interviews, we found that half of the firms have no preference for the venture location. One of investment manager said " I don't limit myself on any particular industry or location and I believe that every project is independent and will be treated separately regardless of their provinces".

Half of the firms preferred to have the investment in the coastal provinces or region near Pearl River Delta or Yangtze River Delta. These are the regions which central government first offered the incentives for foreign investment. It is interesting to note that for those firms who have no preference for their venture location, their present ventures are all in the coastal provinces, Pearl and Yangtze River Delta regions.

One of the firms which had a specific preference about venture location, had a representative office in Shanghai. The manager stated a belief that the enterprises near Shanghai were more mature in terms of the management mentality and the concept of business law. A stock market is available in Shanghai and perhaps most importantly, the venture capital firm had a good network with the Chinese senior officials there, who could exercise some 'high level' influence on the venture management, if necessary.

Stages of financing

As mentioned in chapter 1, the stages of ventures can be classified into five categories; a) seed, b) start-up, c) early, d) expansion, e) pre-IPO. Only two firms also consider 'start-up' venture in their portfolio. The remaining four firms will only invest in existing enterprises that have proven profitable track records. In fact, the firms which consider 'start-up' only have one venture of that kind so far. The remaining investments in their portfolios were all enterprises at the expansion stage.

This phenomenon may be due to several reasons :

a) for start-up, it requires substantial effort from the venture capitalists and a lot of hand holding has to be done before any final products come into the market. Given the lean staff organisations in the firms, the work load is very difficult for the venture capitalists to cope with.

b) It normally requires a longer investment horizon for the start-up venture and it would easily violate the investment policy that the venture goes listing within a short period of time.

c) Typical start-up venture is much more risky which has a longer payback period. Given so many investment opportunities in existing enterprises are available, the opportunity cost of investing in start-up companies would be very high.

Industry preference

All the firms claimed that they have no preference for any particular industry, although they place more emphasis on light or semi-heavy industries. After reviewing their venture portfolios, we found that their investments come from various kinds of manufacturing industry and all produce some fundamental products which are used in daily life. For example, lighting, refrigerators, batteries, silk printing, detergents etc. Among those ventures we studied, there were no investments related to advanced technology. This may be due to the venture capitalists tendency to favour consumer products over technology products, or the inability of the investment mangers to be well-versed about the technology products. This area needs to have further study.

Step 3 - Evaluation

As noted before, many enterprises in search of capital have very little operating history involving a market oriented environment. The evaluation process involves subjectively assessing the venture on a multidimensional set of criteria and validating the information provided by the venture management using the venture capitalist's set of standards and business rules.

Venture Evaluation Criteria

A set of 14 criteria was identified and is shown as below. Not surprisingly, some of the criteria are similar to those found in the new product evaluation model[24] and some of them are related more to the characteristics of joint venture operations in the PRC[11] or newly developed countries. For example, environmental management, raw material supply and balance of foreign exchange.

- Management track record - commitment and competence
- Product niche
- Market Potential - domestic and oversea
- Sales and distribution
- Financial planning
- Industry prospects
- Expected rate of return
- Exit method
- Enterprise reputation
- Enterprise profitable track record
- Venture growth potential
- Environmental management (transportation, communication, electricity and water supply)
- Raw material supply
- Balance of foreign exchange

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24 "Product Management: Strategy and Organisation" by Pessemier, E.A. John Wiley, New York, 1982, p347-351.

Although we intended to ask the venture capitalists to rate the criteria on a point rating scale, the idea was rejected by the interviewees because they felt it was too difficult to bring all the criteria into a deal evaluation and that the feeling rather than the numeric rating on these criteria, is more important in their decision making. Anyway, for the purpose of this study they agreed to name the three most important criteria in their own decision making. The four most popular criteria among the interviewees are :

Management track record

Two of the interviewed firms named this as the most important factor. The track record is referred to the experience and accomplishment of the management team in the venture industry, their vision and future goals, their business sense of running a company in market economy and more importantly, their competence in managing the future venture project. There is no objective measurement on the management issue and the decision is based more on a personal feeling about whether the management team can work with the venture capitalist.

Market potential

The market potential for both domestic and overseas market have to be judged very carefully. A big market share now does not guarantee the same market share five years later and the product life cycle may shorten due to the fast economic growth in the PRC. Also, the firms will study the present competitors and identify any similar venture in the pipeline. As one of the investment manager said "The enterprises in China like to join the horde, the market will be easily become oversupplied. For example, several years ago refrigerator manufacturing was a very promising industry and now the market is oversupplied and the profit margin becomes very low".

Financial Planning

The venture capitalist is to assess how and when the capital is to be spent in the new project. The financial statements and the cash flow projections will be studied very vigorously. Two venture capitalists kept mentioning 'reasonableness' in the investment so whether the money is reasonably spent is a major concern of this criteria. For example, the land cost and the worker payroll as well as the associated benefits will be assessed and compared with other similar enterprises in the industry or within the province, in order to avoid any over-stated or under-stated expenses.

Expected rate of return

It is the measure of the return on the investment and the payback period. Based upon the interviewed capitalists, the norms for the payback period and internal rate of return (IRR) are 5 years and at least 20 percent respectively. Some capitalists even calculated the IRR based on the worst scenario that listing is not available for the exit.

Information validation mechanism

The information can be assessed in the following manner : a) desk review for the financial statements and the accuracy and consistency of the information described in the proposal, b) site visit and c) referral from the industry and government council.

Desk Review

A desk review should be a fairly mechanical process but it is not the case for PRC ventures. There is substantially less publicly information available about Chinese companies than about the Hong Kong companies. The review is one of the most cumbersome processes and it normally has to go through several cycles in order to acquire additional information from the venture management. One of the reasons is the lack of a standard format for business proposals causing the venture management to be unaware of what kind of information the venture capitalists were seeking. For all the interviewed firms, only one of them provided a standard format for business proposals for the venture management.

Also, it is not easy to access the product and market information unless you have the right connection with the government departments and the industry council, said one investment manager. Even though you have that information you must be sure the information is applicable to your venture because there are many statistics prepared by various government departments, and, more importantly, you must know how to interpret it correctly.

Site visit

Seeing is believing. This is one of the most effective ways of checking out the venture as well as the management team. Some venture capitalists even preferred some impromptu site visit to see how the existing shopfloor was managed. That would give a good projection of the performance of venture management when handling the new project.

Referral from the industry and government council

Referrals are important because they enable venture capitalists to seek second opinions from other sources rather than from those related parties who have interests in the venture. Again, it is not a simple task and it depends on the venture capitalist's personal network in government departments and industry councils. One of the interviewed firms appointed several consultants in a university who gave advice and referral. Another firm relied on the fund's China partner to get the required referrals.

Overall speaking, there are no fixed rules for carrying out the information validation stage because of the diversity of the information sources. In many occasions, you may have both positive and negative comments on the venture. According to one investment manager, "the final decision would always come down to personal feeling, rather than the data presented from various sources."

Step 4 - Deal Structuring

If the outcome of the evaluation is positive, the venture capitalist will enter into a deal structuring process where most negotiations take place over the price of the venture, the protective covenants for the venture capital firm, and the investor(s) and their associated equity shares within the venture.

Pricing of the deal

"Pricing was always an area causing controversy", according to one investment manager. In the PRC, the venture is always valued using asset valuations and internal rate of return calculations. The difference in accounting standard in calculating the profit and asset value of the venture was always a stumbling block to getting an agreeable price. For example, the China side calculates the profit using the production basis regardless of the finished goods that are still kept in the stock. One investment manager claimed that 70 percent of the failed deals because of the premium price asked by the China side.

However, this problem should be alleviated as the China government has already established her own accounting standard. It is determined to adhere to the international standard in the future. In fact, the presence of some international accountancy firms can help by giving their view on asset values for both parties.

Protective covenants

As noted before, the covenants are to protect the interests of the venture capital firm as a result of them being in a minority position. The typical covenants include :

- Board of director makeup requires at least two from the investment company and three from the Chinese company. Minimum quorum to call for meeting is three and must at least have one from the investment company.

- To conduct year end audit by an appointed auditor agreed by the investment company and comply with the monthly and quarterly management review requirement.

- The Chinese side to buy back the equity stake at a fair market value if listing is not successful within seven years.

- The investment company will receive each year a stipulated share of profit. In the event of shortfall, any deficiency shall be made up by the Chinese side from its share of distributable profits.

These convenants are all negotiable and depending on the bargaining power between the venture capital firms and the venture enterprise. For example, the venture capitalists may have had the stronger bargaining position when the austerity programme was introduced by Vice-Premier Zhu Rongji, because it was difficult for the venture enterprise to borrow capital from the debt market.

Equity stakes among different investors

In many cases, if the investment amount is particularly large or some special technology is required, the venture capitalist may consider co-investing with other corporate investors or venture capital funds. The ability to find appropriate co-investors and modify the deal such that it meets the best interests of all parties can be one of the competitive edges of venture capital firms, according to one investment manager. He reiterated that the work requires a lot of creativity and in many cases it can convert an impossible venture into a deal acceptable to all parties.

Step 5 - Post-investment activities

This process is referred to monitoring and controlling, cashing out, and other value-added activities. As all the interviewed funds were established for less than three years, we couldn't obtain much information about the funds' exit results. Our discussions are basically for the monitoring and controlling, and some value-added activities.

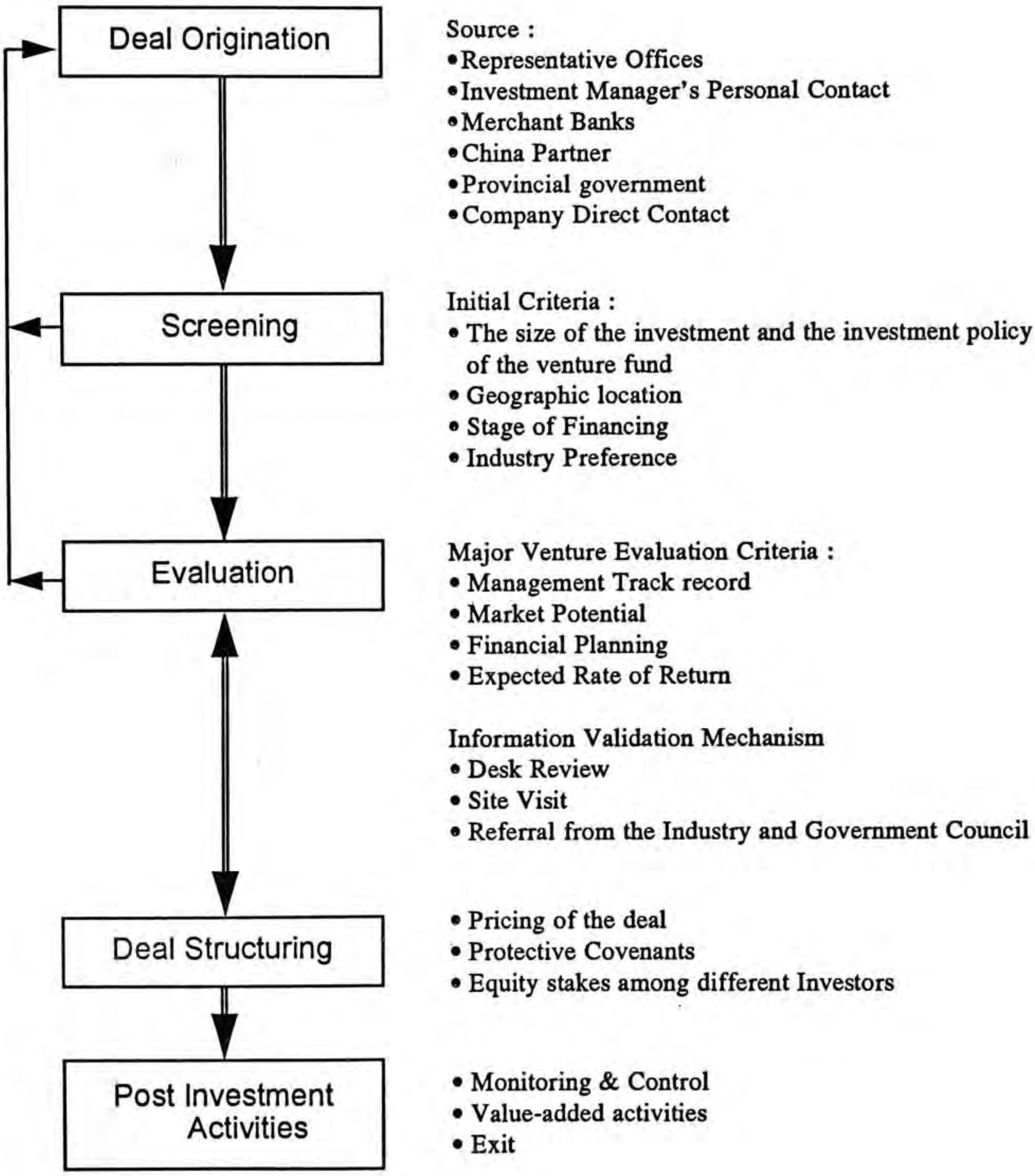
All the interviewed firms agreed that they would leave the day-to-day operation to the venture management, and they all emphasised that importance of controlling area of financial aspects. In order to oversee the financial status, firm A, D and E send accountants to permanently stay in the venture company and work with the management. The other three firms had a different opinion, believing that good accounting and reporting system should be sufficient. However, they all agreed that sending an in-house professional to randomly check the venture operation was necessary.

At this stage, the common value added services provided by the venture capitalists to the venture are i) access to international markets and technology and ii) introduction to strategic partners. For example, one of the venture capitalists successfully aligned an Australian dairy product firm and the Swedish pharmaceutical company to the venture enterprises as business partners.

For all the post-investment activities we discussed with the interviewees, the decision making process for second and subsequent rounds of financing the ventures which are already included in their portfolio was seldom covered.

Fig 6.1

Model of Venture Capitalist Investment Activities in PRC



CHAPTER 7

THREATS AND OPPORTUNITIES FOR VENTURE CAPITALISTS IN PRC

China is an emerging investment market for venture capitalists which is undergoing a period of rapid growth and change. Certainly, there are many risk factors which might lead to the illiquidity in the underlying investments of the portfolio and the possible substantial loss of capital. Several critical factors perceived by the interviewees were revealed and detailed as follow :

Accounting, auditing and financial reporting standards

Chinese accounting and auditing standards in financial reporting are different from those applicable to United States, United Kingdom or Hong Kong companies. In particular, the assets and profits appearing on the financial statements of a Chinese company may not reflect its financial position in the way such information would be reflected in financial statements prepared in accordance with Hong Kong generally accepted accounting principles. Major differences are found in areas such as provision for inventory obsolescence, preparation of consolidated accounts, valuation of properties and other assets, accounting for depreciation, deferred taxation and contingencies and treatment of exchange differences.

The problem should be alleviated since the central government indicated a determination to adhere to the international accounting standards as stated in the party policy[25] in July 1993 at the Chinese Communist Party's 72 anniversary. However, there is still no specific plan to enforce the standard implementation by provincial government and it still requires some time before the Chinese companies can fully adopt the new standards. At the moment, most of the venture companies have to prepare two sets of financial reports for the use in China and the venture capital fund in Hong Kong.

China stock market, corporate and securities laws

At present, there is no clear nationwide framework of laws and regulation governing stock markets in China, including company codes regarding fiduciary duties of officers and directors of a company, acquisition regulations, and securities transaction rules. The listing requirements are vague, and how a company values its assets for the purpose of securitisation is even more

25 The new system, entitled Business Accounting Standards and the General Rules of Financial Affairs for Enterprises, went into effect on 1 July 93. Based on international standards for establishing capital funds, cancelling fund deposits with special accounts, and cost management, the new system is aimed to help state enterprises become independent and enable them to compete on an equal footing.

obscure[26]. The listing prospect is greatly controlled by the government regardless of the venture company's value and profitability history. For example, on 12th Mar 94, the government announced the delay of the listing of new stock by at least half a year in order to limit the supply of B shares with the aims to avoiding the further falling of share prices[27]. This kind of intervention action has a severe negative impact on both the stock market and the 'would-be' listed companies.

This is a major concern for venture capitalists as public listing is regarded as the desirable exit method and they all have a designated listing time horizon for their investment portfolio. In our study, some venture capitalists have already arranged the deal in order to allow the ventures to be listed in some other stock markets.

Competition with other venture capitalists and corporate investors

Many venture funds didn't acquire sufficient deals[28], and as a result, have left a large portion of their venture fund idle. The venture firms not only have to compete among themselves for a good deal, but also

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26 "China's Capital Market" by Hu Yebi, The Chinese University Press 1993, P69-74.

27 Hong Kong Economic Journal, P.22, 16 March 94.

28 Hong Kong Economic Journal, P10, 12 March 94.

have to compete with other corporate investors. These corporate investors normally have a similar business nature as the venture companies and they want to form business partnership with the venture enterprise in order to achieve some long-term and strategic goals. The provincial government would prefer corporate investment because they would help build up the marketing and management skills for the venture management. The investment by venture capitalist is purely financial, which is preferred by some ventures with well-established management because they have more freedom for decision making in their day-to-day operation. In this regard, venture firms can take a more pro-active approach to attract potential ventures. Activities like general and target marketing for specific industry sectors can also be considered.

Exchange Rate movements

As the investment in the PRC is not denominated in the fund's accounting currency - mostly US dollars, it poses a threat to the net asset value of the portfolio as a result of the devaluation of RMB against USD. Although the value of RMB is designated to a controllable fixed rate with US dollar at 8.7 by Bank of China at January 1994, further devaluation of RMB is likely to occur in future. It may have a material effect on the earnings and the asset values of the investee companies.

However, the interviewees shared an optimistic view on that issues. They felt that if the venture growth is sufficient to compensate the currency depreciation, it is still a viable choice for venture capitalist to invest in the PRC. In addition, the venture company can mitigate by natural hedging, for example, by using foreign currency from exports of finished products to pay for imports of raw materials.

Political instability

The value of the investee companies' assets may be adversely affected by the political instability in China. For example, the unrenewal of China's "Most favoured Nation" trading status by US, the fuelled inflation in China which subsequently causes the loss of power of the reformist, the death of Deng etc. According to one interviewee, "You cannot do much about that. There is no hedging on these risks. As long as you're investing in PRC, you have to accept these risks."

CHAPTER 8

CONCLUSION

The purpose of the study is two-folded, namely a) to analyse and model the investment activities of the venture capitalists in PRC, b) to identify the threats and opportunities in the industry as perceived by the venture capitalists.

With respect to the first objective, the value of the study is barely achieved by using a simple sequential five-step model. As compared with other rigorously specified model, the sequential five-step model lacks of theoretical basis and is highly descriptive, but we found that it is more appropriate and comprehensive to reflect the heterogeneity in the practices of different venture capital firms in PRC. As there is a growing number of venture capital funds for PRC and many of them are government sponsored, it might require a more sophisticated process model in order to reflect the venture capitalists' investment activities in PRC.

The second objective is to identify the threats and opportunities in the venture capital industry with regard to the present economic and political environment of PRC. Several factors were explored, namely a) accounting, auditing and financial reporting standards, b) China stock market, corporate and securities laws, c) competition with other venture capital fund and corporate investor, d) exchange rate movements. In view of the rapid economic growth and the continuous economic reform in the PRC, the role of venture capital funds has become increasingly significant in filling the capital gap. These factors, though not exhaustive, should be able to provide a starting point for any future study in the field of venture capital in PRC.

Future Research

In view of the growing number of venture capital funds in the PRC and the maturing of the industry, there are several fertile areas that can be explored. For example, the empirical study of the evaluation criteria (step 3 - evaluation) using point scale rating, the decision making process for second and subsequent rounds of financing for ventures already in the portfolio, the correlation of the success or failure of the venture with regard to venture capitalist's evaluation criteria etc.

APPENDIX I

INTERVIEW GUIDE

A. CHARACTERISTICS OF THE FIRM (Venture Organisation Structure)

- Ownership of firm
- Capital size
- Staff size, Function and Experience ?
- Who screens ventures ?
- Who is the investment decision-maker?
- Type of investment
- Registered country

B. SEARCH

i. How does the venturist learn about ventures ?
- Active Search
- Mgt. team contact, cold
- Mgt. team contact, referral
- Venturist contact, prior deals
- Venturist contact, no prior deals
- Prior investee or personal acquaintance
- Gov't agency referral

ii. How do the number of proposals received by the venturist vary over time?
- Government policy e.g. tax policy, austerity programme, etc.
- State of economy

iii. What is the participants of the proposed venture(s)
- Principal investor and the venturist
- Lead venturist, 1 or 2 other venturists etc...

iv. What is the stage of development when first financed?
- Start-up
- Growth, less than 5 years
- Growth, more than 5 years
- Buy-out

C. Screening

i. What is the venturist's preference with regard to

- Industrial class (how would this change over time)
- Geographical location
- Size of financing (maximum, minimum)
- Stage of development (concept, start-up, growth, refinancing, acquisition, merger)
- Present sales volume of the venture
- Potential market size
- Venture product (high-tech, consumer, commodity, services)
- Profitability of the venture
- Financing group (lead venturist, with other venturist, prior deals?)
- Prior experience of management team (in the areas of marketing, R+D, administrative and manufacturing etc.)
- Completeness of management team
- Control over venture
- Chance of listing the venture

D. Evaluation

i. How does the venturist check information for accuracy ?

ii. What sources does the venturist use for information?

iii. How is management evaluated ?

iv. What is the consideration for risk factor ?

v. How is risk measured ?

vi. What formal requirements are there, such that if they are not met, the venture is automatically rejected?

vii. How often and how does the venturist modify ventures?

viii. What % return on investment, compounded and over all ventures is expected?

ix. How long is the venturist's investment horizon ?

x. Which of the above factors is most important for the consideration ?

E. Bargaining, Financing, and Competition

i. What does the venturist offer the firm ? (business partner, contacts, management skill, listing opportunities)

ii. When does bargaining take place between the venturist and management team?

iii. How is the deal structured ? (Is the % equity position made variable with venture performance ?)

iv. How often are ventures found acceptance except the price (Any examples) ?

v. Are there times that the venturist decides to invest a venture and instead management team rejects his offer (Any examples) ?

F. Cashing out

i. How does the venturist decide to cash-out ? (To whom? other investors, the public, merge etc.)

ii. Does the venturist have the authority to sell or merge a company?

iii. Does the venturist encourage merges to get cash or marketable stock? Under what conditions?

G. The nature of the Venturist's work

Average % time spent in Activity

Search	______
Screening	______
Evaluation	______
Venture Board Meetings and follow-up	______
Venture Operations	______
Cashing-out	______

H. Identify 3 key factors in decision making

Management Marketing Skill _____

Degree of Management commitment _____

Method of Cashing-out _____

Recommendations of others who are respected _____

Who else is in the deal _____

Product _____

Management Engineering skill _____

Marketing Plan _____

Industry/Technology _____

Management manufacturing skill _____

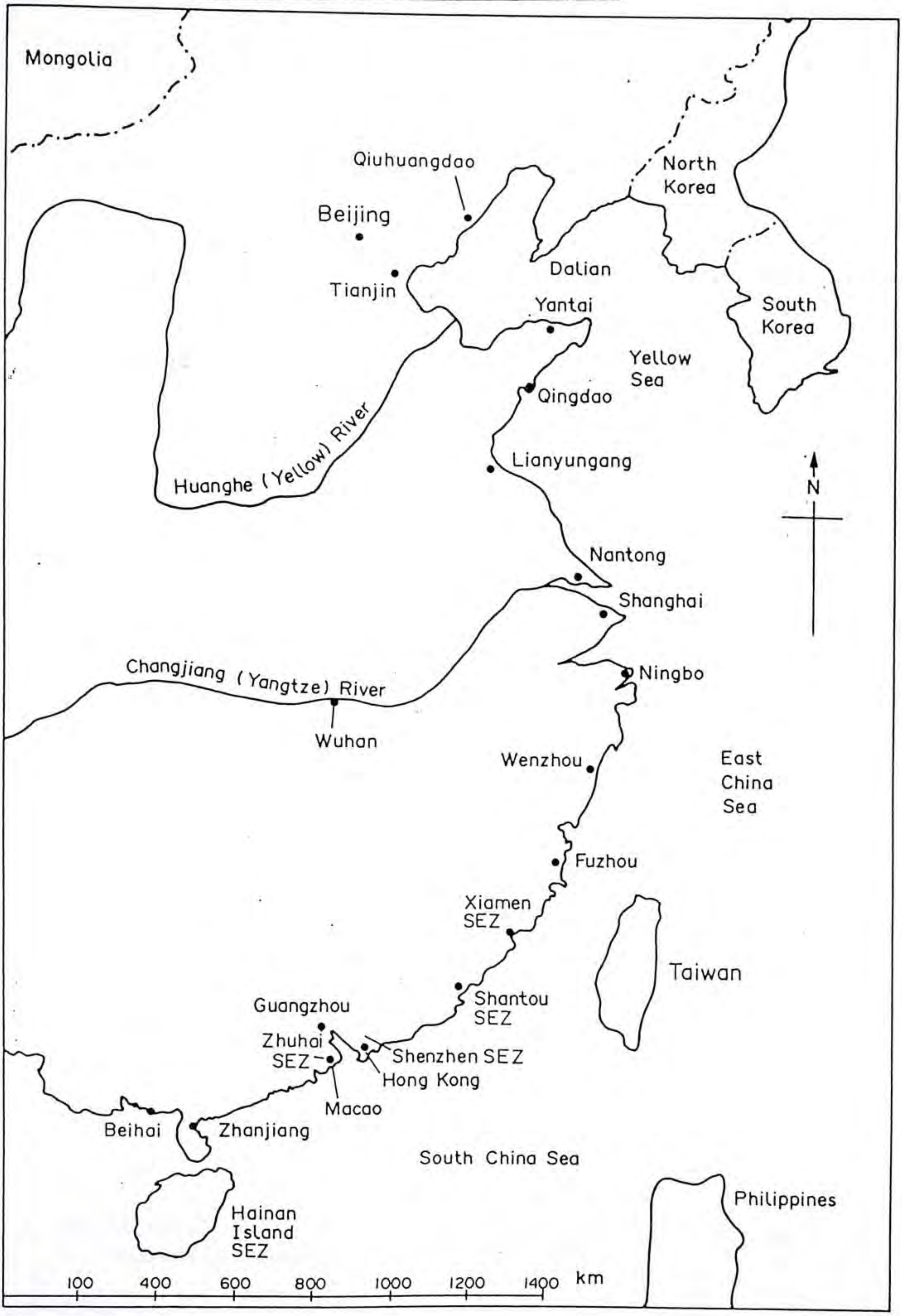
The potential growth of the Venture _____

Others Pls specify ____________________

APPENDIX II

MAP OF CHINA'S COASTAL CITIES

MAP OF CHINA'S COASTAL CITIES



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